

Office of the Governor of Texas
Management's Response to State Auditor's
Audit Report on the Emerging Technology Fund

Summary of OOG Management's Response

The Office of the Governor of Texas (OOG) appreciates the State Auditor's Office's (SAO's) review of the Texas Emerging Technology Fund (TETF). The members of the SAO's audit team were consistently courteous, professional, and supportive of the OOG's audit response team. In this report, the SAO has made several valuable recommendations for improving the TETF program, and the OOG is pleased to implement them as described further below.

In particular, the OOG generally agrees with the SAO's identification of opportunities to improve the OOG's monitoring and enforcement of TETF recipients' compliance with their contractual obligations. To that end, the OOG has recently completed an internal review of grants and grant monitoring across the board, the results of which have led to the creation of a Compliance and Oversight Division (COD) within the OOG. The COD will substantially improve the compliance process within the TETF and other OOG funded programs, by combining and leveraging existing resources within the OOG. This new COD employs professional auditors and contract compliance staff who, individually and collectively, have extensive monitoring and auditing experience. The OOG has allocated additional resources to the review of compliance reports, and will soon be implementing new and additional procedures to improve this process.

The OOG disagrees, however, with some of the SAO's conclusions and recommendations. We believe there are at least two primary reasons why these disagreements remain despite our mutually cooperative relationship with the SAO's audit team.

First, we believe the disagreements result from the SAO's selective focus on certain aspects of the TETF program to the exclusion of others. For example, the SAO focused extensively on how the program addresses potential conflicts of interest, presumably because that issue has received extensive media attention over the past several months. This is certainly an appropriate area on which to focus an audit such as this. The SAO report, however, never addresses the question of "whether the Office of the Governor disburses funds from the ETF in accordance with Texas Government Code, Chapter 490," which was the SAO's first stated objective of the audit. Presumably, if the SAO had found that the OOG has disbursed funds in violation of Chapter 490, it would have said so in its report. Its focus on other issues appears to have distracted it from confirming that the OOG *has* acted in accordance with the statute.

Second, we believe that the disagreements result in large part from the SAO's misunderstanding of the nature and role of the entities and individuals involved in the TETF program and, at least in some respects, the very purposes of the program itself. For this reason, it is worth quoting directly from the statute that describes and defines those purposes:

PURPOSES. The [TETF] is established under this chapter to *develop and diversify the economy of this state* by:

- (1) *expediting* innovation and commercialization of research;
- (2) *attracting, creating, or expanding* private sector entities that will promote a substantial increase in high-quality jobs; and
- (3) *increasing* higher education applied technology research capabilities.

TEX. GOVT. CODE § 490.002 (emphases added).

At a minimum, we believe that the OOG and SAO have a fundamental disagreement over the best ways to accomplish these purposes while balancing the various competing interests that must be considered. The OOG absolutely agrees, for example, that consistency, transparency, and accountability are valuable at all levels of the TETF process. But effectively protecting and promoting those values in light of the legislatively-defined purposes of the program requires an accurate and proper understanding of the nature and roles of each of the entities and individuals involved.

The OOG's responses in the following chapters will explain in detail why the OOG disagrees with many of the SAO's conclusions and recommendations. Our disagreements, however, do not lessen our appreciation for the SAO's efforts, and for the professionalism and courtesy of its audit team members. The OOG looks forward to continuing these discussions on how to improve the effectiveness of this very important program.

Chapter 1-A: "The ETF Should Improve Consistency, Transparency, and Accountability at the RCICs and the Texas Life Science Center."

Chapter 1-A of the SAO's report overlooks the importance of the fact that each organization that serves as a Regional Center for Innovation and Commercialization (RCIC)¹ is a separate non-profit entity that is independently governed and operates within its own local geographical area. The Austin Chamber of Commerce, for example, serves as the Central Texas RCIC, the Houston Technology Center serves as the Gulf Coast RCIC, the Alliance for Higher Education operates the North Texas RCIC, and the Northwest Texas Small Business Development Center operates the West Texas RCIC. The OOG did not originally fund these independent entities, and currently provides them only with matching funds to support the TETF aspects of their broader operations.

¹ For reasons unrelated to the audit, the OOG previously decided not to renew the Life Science Center for Innovation and Commercialization, but to instead distribute the expertise of that entity around the state through the RCICs. In light of this, the OOG's responses will refer to all of the Centers collectively as RCICs.

By design, each RCIC serves unique populations and geographical areas. Their ability to tailor their processes to their unique customers and to adapt their models to their local business climate is a key asset for successful economic development throughout the State. For this reason, each RCIC operates independently, under the leadership of its own board of directors, and is governed by its own organizational documents and by-laws. In light of this, the SAO's call for complete "consistency" in the RCIC's practices would be impractical and, we believe, counter-productive.

The SAO also fails to appreciate both the uniqueness of and the limitations on the statutorily-created role that the RCICs play in the TETF process. As defined by the Legislature, the RCICs engage in research and development, provide commercialization for the results, serve as incubators for new business opportunities, and provide workforce training for the resulting endeavors. TEX. GOVT. CODE § 490.152(c). At quarterly Application Presentation Days, they discuss the merits of each TETF applicant with the Advisory Committee, thus combining local input with statewide guidance in accordance with the ideal model for economic development in the state of Texas. But they only make funding *recommendations* to the Advisory Committee. The Advisory Committee, in turn, makes *recommendations* to the Governor, Lieutenant Governor, and Speaker of the House of Representatives (the TETF Trustees), who are the only ones with legal authority to make the funding decisions. The RCICs do not make any decisions to determine which entities will receive funds or how much any grant will be.

The SAO also misstates TETF processes when it states that TETF has "an informal process through which an applicant can apply to RCICs outside the applicant's home region." The TETF does have a "Conflict of Interest Escalation and Resolution Policy," which permits an applicant "to reapply to any other RCIC," but only when there is a "perceived conflict of interest" between the applicant and its local RCIC. And, while the SAO is correct that the TETF "does not provide that policy to applicants when they apply for funds," this is because the applicants apply to the RCICs, not to the TETF. The TETF, which is typically not aware of the applications at that point, has provided the policy to the RCICs, which actually receive the applications and thus can advise the applicants of this policy.

Finally, the SAO discounts the legitimate need for confidentiality for some of the information that the RCICs receive and review, which is a standard business practice considering the competitive and delicate nature of the emerging technology industry. This is an example of when the need for transparency must be balanced against the statutory purposes of the TETF program. The Legislature has expressly recognized this, and has expressly provided that information regarding the "identity, background, finance, marketing plans, trade secrets, or other commercially or academically sensitive information of an individual or entity being considered for an award" is confidential by law. TEX. GOVT. CODE § 490.057. To protect and promote the economic interests that the TETF is designed to encourage, the SAO's call for greater transparency must take into account this statutory confidentiality.

Nevertheless, as the TETF program has developed and matured, the OOG has recognized the value of encouraging consistent practices and implementing uniform policies and procedures

whenever doing so would improve the program without undermining the value of the RCICs' independence and role in the process. For example, the OOG provides a standard format for all applications and presentations to be provided by the RCICs to the Advisory Committee and the OOG. And, in 2010, the OOG began to contractually require all RCIC board members to sign a conflict of interest disclosure statement even though, as the SAO acknowledges, five of the RCICs already had their own internal conflict of interest policies. The OOG has not required that all RCIC staff members and review committee members sign such a statement (although, as the SAO has acknowledged, most do), because the staff members have no vote in the application review process.

Based on these comments and considerations, the OOG responds to the SAO's Chapter 1-A recommendations as follows:

SAO Recommendation 1-A (1): Establish a contractual requirement that the RCICs and the Texas Life Science Center

- **maintain minutes from board meetings, which, at a minimum, should document which applicants were recommended to the Advisory Committee for funding, and publish such minutes on the RCIC's web sites; and**
- **document how individual board members' and application review committee members vote on each application, including their recusals and reasons for their recusals.**

The OOG agrees in part with this recommendation. The OOG agrees to contractually require each RCIC to maintain board meeting minutes that document which applicants the RCIC decides to recommend to the Advisory Committee for funding, the individual board members' votes on those decisions, and any board member recusals, and to require the RCICs to submit these minutes to the TETF. The OOG's General Counsel and TETF divisions will be responsible for implementing this change beginning with the next RCIC contract.

The OOG does not agree to contractually require the RCICs to maintain minutes that identify the applicants that the RCICs decide *not* to recommend for funding, because the public identification of these applicants serves little, if any, legitimate public purpose, and publication of the fact of their rejection by the RCIC would likely jeopardize the future success of these small Texas businesses. This would be the equivalent of publicizing the identities of small Texas businesses that failed to qualify for loans, or of families who were rejected for a mortgage loan. Such publication would unnecessarily harm reputations and undermine opportunities for future financing.

The OOG does not agree to require documentation of how application review committee members vote on each application, because these review committees merely provide guidance to the RCIC board members (which in turn, make recommendations to the Advisory Committee, which, in turn, merely makes

recommendations to the TETF Trustees who, again, are the only ones who can make the funding decisions).

The OOG does not agree to contractually require the RCICs to post their minutes on their web sites, because the applicants that the RCICs decide to recommend for funding are not guaranteed to receive funding, as they must still obtain the Advisory Committee's recommendation, and then the TETF Trustees must make the funding decision. More than 92% of the companies that apply to an RCIC for a commercialization award *never* receive any funds from the TETF. Publicizing the identities of these rejected applicants serves little, if any, legitimate public purpose, and would jeopardize the future of these business endeavors. Moreover, a requirement to publish minutes on a web site would have to be limited to protect confidential information under section 490.057.

SAO Recommendation 1-A (2): Clarify with the RCICs that the contractually required conflict of interest disclosure policy applies to both ETF applicants and recipients.

The SAO's report does not adequately identify any past problems that would require such a change. Nevertheless, the OOG agrees to provide such clarification. The TETF division will be responsible for implementing this recommendation, and will do so within 30 days after the publication of this report.

SAO Recommendation 1-A (3): Contractually require RCIC board members to report any investments they make in or compensation they receive from TETF recipients after the conflict of interest disclosure policy allows them to make such investments or receive such compensation.

The OOG agrees with this recommendation. The OOG's General Counsel and TETF divisions will be responsible for implementing this change beginning with the next RCIC contract.

SAO Recommendation 1-A (4): Contractually require RCIC staff and application review committee members to sign conflict of interest disclosure statements.

The OOG agrees with this recommendation. The OOG's General Counsel and TETF divisions will be responsible for implementing this change beginning with the next RCIC contract.

SAO Recommendation 1-A (5): Contractually require the RCICs to immediately report in writing to the TETF any disclosed conflicts of interest and how those conflicts of interest were resolved.

The OOG agrees with this recommendation. The OOG's General Counsel and TETF divisions will be responsible for implementing this change beginning with the next RCIC contract.

SAO Recommendation 1-A (6): Make the TETF's Conflict of Interest Escalation and Resolution Policy available to applicants on the RCIC's and TETF's web sites.

The OOG agrees with this recommendation. The TETF and IT divisions will be responsible for posting the policy on the TETF web site, and will implement this change within 30 days after the publication of this report. The OOG's General Counsel and TETF divisions will be responsible for contractually requiring the RCICs to post the policy on their web sites, and will implement this change beginning with the next RCIC contract.

SAO Recommendation 1-A (7): Develop substantive criteria for the RCICs to follow when evaluating applications and make those criteria available to the public.

The OOG agrees in part with this recommendation because, in fact, the TETF has already developed appropriate criteria, which are already published on the TETF and RCIC web sites. As discussed above, however, the OOG does not agree that RCICs should be required to utilize detailed standardized criteria, because the RCICs' ability to tailor their processes to their unique customers and to adapt their models to their *local* business climate is a key asset for successful economic development throughout Texas.

Chapter 1-B: "The Legislature and the ETF Should Improve Transparency and Accountability for the Advisory Committee."

The SAO's review of the Advisory Committee, like its review of the RCICs, fails to recognize the limited role that the Advisory Committee plays in the TETF process. The Advisory Committee consists of volunteers who are able to provide valuable expertise because they are "industry leaders in this state or . . . are nationally recognized leaders from public or private institutions of higher education in this state." TEX. GOVT. CODE § 490.052(b). Because of the knowledge, experience, and successes of its individual members, the Advisory Committee is able to professionally evaluate the applicants that the RCICs recommend for funding, and then decide which of those applicants it will recommend to the TETF Trustees. But it is then the Trustees, and not the Committee members, who decide which applicants will receive the funds. The Advisory Committee has no power or authority to encumber or appropriate state funds.

For this reason (among others), the programs of the 10 other states to which the SAO's report refers (and to which all of Chapter 5 of the SAO's report is dedicated) are, in fact, not at all "similar" to the TETF. Those states' programs are governed by a board or a commission that has direct authority to make funding decisions for their state. For the same reasons, the SAO's comparison of the Advisory Committee to the boards of the University of Texas Investment Management Company and the Texas Teachers Retirement System is not valid because the Advisory Committee has no governing authority and does not award funds or make the funding decisions. Comparing these entities with the TETF Advisory Board is both misleading and inaccurate.

The SAO's suggestions for increased transparency of the Advisory Committee's activities are appropriate, but must be balanced against the goal of encouraging the formation and participation of successful ventures and the need to protect those companies' ability to succeed in the competitive emerging technology industry. At a minimum, the confidentiality requirements that the Legislature has expressly imposed in Section 490.057 must be preserved. Moreover, most of the applicants that the Advisory Committee considers and discusses do not ultimately receive TETF funds, and the public identification of the identities of those companies and of the Committee's evaluation of them would be of little, if any, legitimate public interest, and would likely jeopardize their future business and job creation success.

For these reasons, the SAO's suggestion that the Advisory Committee should conduct open meetings and should maintain and publicize meeting minutes must be viewed with caution. The Committee does record and report the total vote count on each of its recommendations, on any member's recusal from that vote, and on the Committee's recommended milestones for each company. Pursuant to the Committee's code of ethics, members are required to "promptly" disclose all potential conflicts of interest. The letter that the TETF director sends to the TETF Trustees to confirm the Advisory Committee's funding recommendations specifically lists the vote counts, as well as any recusals.

The OOG disagrees with the SAO's conclusion that "it is not possible to evaluate how the Advisory Committee addresses disclosures of conflicts of interest." The code of ethics specifically describes how the Committee addresses such disclosures, and additional documents provided to the SAO demonstrate how it has in fact done so. Moreover, the SAO's conclusion that, in reference to a specific past situation, "it is unclear whether the Advisory Committee member who had the consulting contracts voted to approve those additional disbursements of funds," is simply incorrect because it ignores the documents that show how that individual followed the code of ethics requirements, fully disclosed his interests, and was either not yet on the Advisory Committee during the initial voting or recused himself from future votes on additional disbursements.

When the SAO's report states that an "Advisory Committee member was on the Advisory Committee when ... two recipients were approved for *subsequent* disbursements of ETF funds," it omits the fact that the Advisory Committee member was *not* on the Advisory Committee when the Committee originally made the decision to recommend that the award be

made, and therefore he had no possibility of a conflict of interest at that time. It further omits the fact that, after he became a member of the Committee, he recused himself and did not participate in any votes when the Committee considered whether to recommend subsequent disbursements to these recipients.

In concluding that the Advisory Committee “does not follow consistent processes,” the SAO’s report ignores the written criteria and processes, sample contracts, and process graphs that have been posted on the TETF’s and the RCIC’s web sites since 2007. (See, e.g., “Subchapter D, Commercialization Funding Criteria (PDF)”, “The Subchapter D, Commercialization Application Process (PDF)”, “Subchapters E and F Application Process(PDF)”, and “Standard Due Diligence by the Office of the Governor (PDF).”) The TETF has continually developed and improved these processes over the life of the fund, and will continue to do so.

When the SAO’s report states that “the Advisory Committee recommended a commercialization award for an application that had not been approved by an RCIC,” and that “the former ETF director intervened to forward an application,” the report fails to note that, in that situation, the RCIC itself sought such relief due to a possible conflict of interest and requested that the Advisory Committee consider the application. No law or policy prohibited that reasonable approach to resolving the possible conflict, and the TETF then adopted the Conflict of Interest Escalation and Resolution Policy to formally approve that alternative approach if that situation ever arises again.

Based on these comments and considerations, the OOG responds to the SAO’s Chapter 1-B recommendations as follows:

SAO Recommendation 1-B (1): The Legislature should require the Advisory Committee to follow the Open Meetings Act or selected provisions of the Open Meetings Act, such as posting agendas and notices of meetings and recording meeting minutes.

The OOG disagrees with this recommendation because it ignores the nature and the statutory role of the Advisory Committee. The Advisory Committee is not a governmental body, and it does not receive, encumber, appropriate, or distribute state funds, or decide how state funds should be appropriated or distributed. It serves only in an advisory capacity. In doing so, it receives, evaluates, and discusses detailed information regarding small Texas businesses, most of which never receive state funds. Publicly disclosing this detailed information regarding the companies that are *not* recommended to receive public funds would serve little, if any, legitimate public purpose. Doing so would disclose not only the detailed business information that is protected under section 490.057, but also the fact that the Advisory Committee decided not to recommend the company for funding. This would likely jeopardize the future success of these companies. Moreover, disclosing detailed information regarding the entities that the TETF

Trustees *do* ultimately decide to fund would place the taxpayer's investment in those entities at an extreme competitive disadvantage, and would undermine the TETF's statutory purpose to "expedit[e] innovation and commercialization of research." TEX. GOVT. CODE § 490.002.

SAO Recommendation 1-B (2): The Legislature should require the Advisory Committee and its subcommittees to document and retain a record of each member's votes, recusals, and the specific nature of any disclosed conflicts of interest and the resolution to those conflicts of interest.

The OOG agrees that the Advisory Committee should document and retain a record of each member's vote when deciding whether to recommend that the TETF Trustees fund an applicant. The OOG does not agree that subcommittees should be required to do the same, unless the subcommittee is acting on behalf of the Committee such that the subcommittee will be submitting its recommendation directly to the TETF Trustees. The OOG already requires the Advisory Committee to maintain a record of any member's recusal, the specific nature of any disclosed conflicts of interest, and how those conflicts were resolved.

SAO Recommendation 1-B (3): The Legislature should change the composition of the Advisory Committee to include two senators and two representatives appointed by the Lieutenant Governor and the Speaker of the House of Representatives, respectively.

The OOG has no objection to these recommendations, so long as all Committee members are "[emerging technology] industry leaders in this state or . . . are nationally recognized leaders from public or private institutions of higher education in this state," as required by section 490.052(b).

SAO Recommendation 1-B (4): The Legislature should require Advisory Committee members to file annual financial disclosure statements with the ETF.

The OOG disagrees with this recommendation because it is unnecessary and it would undermine the valuable role that the Advisory Committee plays. The Committee has no authority to allocate state funds. Its members are completely uncompensated volunteers who are extensively involved in their own, unrelated, successful business endeavors. The code of ethics already requires Committee members to disclose those financial interests that create a potential conflict of interest.

SAO Recommendation 1-B (5): The TETF should work with the Advisory Committee to develop written policies and procedures for accepting, evaluating, and recommending applications for the ETF, which policies should ensure that the Advisory Committee votes on all applications before applications are sent to the Trustees for consideration for funding.

The OOG agrees with this recommendation, and has been doing this since the TETF was formed.

SAO Recommendation 1-B (6): The TETF should revise the Advisory Committee code of ethics policy to prohibit Advisory Committee members from investing in or receiving compensation from ETF recipients.

The OOG agrees that the code of ethics should prohibit Advisory Committee members from investing in or receiving compensation from a TETF recipient if the member previously participated in Committee discussions or votes related to that recipient. The General Counsel and TETF divisions will be responsible for implementing this revision to the code of ethics prior to the signing period in July/August 2011.

For other situations in which a member may have dual interests, such as when a company in which a member has a pre-existing financial interest appears as an applicant before the Committee, the code of ethics already requires the Advisory Committee member to promptly disclose the interest; requires, at a minimum, that the member recuse himself or herself from any discussions or votes regarding that applicant; and prohibits the Advisory Committee member from using his or her position on the Committee “to seek or obtain personal gain or benefit beyond any properly authorized compensation or expense reimbursement.” Prohibiting Committee members from having a financial interest in any and all businesses that apply would both prevent promising companies from applying and discourage experienced entrepreneurs from volunteering their services and thus deprive the TETF Trustees of their valuable advice.

SAO Recommendation 1-B (7): The TETF should revise the Advisory Committee code of ethics policy to require that all Advisory Committee members sign required conflict of interest statements prior to participating in Advisory Committee deliberations and voting on applications.

The OOG agrees with this recommendation, but would note that the code of ethics already requires each Advisory Committee member to sign the required statement at the time of their initial appointment to the Committee and then annually in July or August thereafter. The only members who have not signed and submitted the statement are those who were appointed and already serving before the written code of ethics was adopted in October 2010, but they too will be required to sign

and submit the statements in July/August 2011. In the meantime, the code of ethics expressly provides that, “[b]y serving or continuing to serve as a Committee Member, as applicable, each Committee Member accepts this Code and agrees to comply with its provisions.” These Committee members are therefore bound by the code of ethics even though they have not signed the form.

SAO Recommendation 1-B (8): The TETF should revise the Advisory Committee code of ethics policy to require Advisory Committee members to disclose conflicts of interest in writing, and require the Advisory Committee to record any disclosures and associated resolutions in the meeting minutes.

The OOG agrees with this recommendation. Whenever Committee members have a potential conflict of interest, the code of ethics requires them to disclose that fact and recuse themselves while other Committee members discuss the disclosure and decide upon the proper resolution. We agree that the Committee should be required to document the disclosure in writing, if the disclosing member has not already done so, and the Committee should also document the process followed and the chosen resolution. The General Counsel and TETF divisions will be responsible for implementing any revisions to the code of ethics that are necessary to clarify and confirm these requirements, and will do so prior to the next annual signature period in July/August 2011.

SAO Recommendation 1-B (9): The TETF should revise the Advisory Committee code of ethics policy to require Advisory Committee members to disclose whether they have a financial interest in an applicant prior to voting on an application.

The OOG agrees with this recommendation. The code of ethics already requires Advisory Committee members to “make a full and fair disclosure of all matters that could diminish his or her independence and objectivity or conflict with his or her duties as a Committee Member,” and to do so “promptly.” Although we believe that “promptly” means “prior to voting on an application” in which the member has a financial interest, we will revise the code of ethics to make this more explicit. The General Counsel and TETF divisions will be responsible for implementing this revision, and will do so prior to the next annual signing period in July/August 2011.

SAO Recommendation 1-B (10): The TETF should revise the Advisory Committee code of ethics policy to require Advisory Committee members to receive training in conflicts of interest, open meetings, requirements, and open records requirements.

The OOG agrees in part with this recommendation. The General Counsel and TETF divisions will be responsible for revising the code of ethics policy to require Advisory Committee members to receive training in conflicts of interest, and will do so prior to the next annual signature period in July/August 2011. The

OOG does not agree that the Committee members should be required to receive training in open meetings and open records requirements, because the Texas Open Meetings Act and the Texas Public Information Act do not apply to the Advisory Committee.

Chapter 1-C: “Accountability Should Be Improved Within the ETF Office.”

The OOG agrees that increased accountability within the TETF is valuable, but it does not agree with several of the conclusions on which the SAO bases this recommendation. The TETF, for example, has adopted policies, criteria, procedures to govern the application process, sample contracts, and process graphs that have been posted on the TETF’s and RCIC’s web sites since 2007. (See, e.g., “Subchapter D, Commercialization Funding Criteria (PDF)”, “The Subchapter D, Commercialization Application Process (PDF)”, “Subchapters E and F Application Process(PDF)”, and “Standard Due Diligence by the Office of the Governor (PDF).”). The OOG also provided the SAO a series of charts and graphs that detail each decision point for the funding applications, along with several other policy and procedure documents. The SAO refers to and makes recommendations regarding these policies and procedures throughout its report. Its real concern, then, cannot be that “there are no policies for the ETF application process,” but is apparently that the policies and procedures “are not all signed and do not have effective dates.”

Without regard to the bases for the SAO’s conclusions, the OOG does agree that increasing accountability can be beneficial to the program, its participants, and the taxpayers who fund it. Based on these comments and considerations, the OOG responds to the SAO’s Chapter 1-C recommendations as follows:

SAO Recommendation 1-C (1): The ETF should develop written policies and procedures for the ETF.

The OOG agrees in part with this recommendation. The TETF has already developed written policies and procedures, but has not adopted the format or organization (including a formal numbering, dating, and signature system) that the SAO prefers. The TETF division will be responsible for exploring the implementation of such a system as it continues to develop its policies, and will continue to make the policies publicly available through its web site.

SAO Recommendation 1-C (2): The ETF should provide consistent and complete documentation to the trustees, including the amount of matching funds recipients must provide.

The OOG agrees to continue providing consistent and complete documentation to the TETF Trustees, and to include the amount of matching funds that the Advisory Committee recommends the recipient must provide. The TETF will be responsible for implementing this recommendation, and will do so upon

publication of this report. Pursuant to Texas law, the TETF Trustees will continue to decide the amount of the required matching funds.

SAO Recommendation 1-C (3): The ETF should clarify the amount of matching funds recipients must provide in both (1) trustee commitment letters and (2) contracts for research matching grants and research superiority grants.

The OOG agrees to recommend to the TETF Trustees that they include specific matching funds amounts in commitment letters, and to include such amounts in contracts for research matching grants and research superiority grants. The TETF and General Counsel divisions will be responsible for implementing these recommendations, and will do so upon publication of this report.

SAO Recommendation 1-C (4): The ETF should ensure that all ETF staff sign a statement of compliance with the ethics policy and complete outside employment forms when required.

The OOG agrees to ensure that all ETF staff sign a statement of compliance with the ethics policy and complete outside employment forms when required. The TETF and HR divisions will be responsible for implementing this recommendation, and will do so upon publication of this report.

SAO Recommendation 1-C (5): Prior to submitting applications to the ETF Trustees, the ETF should:

- **require applicants to obtain federal and state criminal history background checks on their officers and investors and send the results of those checks to the ETF office;**
- **conduct credit checks on applicants' officers and investors; and**
- **obtain photo identification for commercialization award applicants' officers and investors, and research any U.S. Securities and Exchange Commission penalties levied against commercialization award applicants, their officers, and their investors.**

The OOG agrees with these recommendations. The COD and the TETF division will be responsible for implementing these recommendations, and will do so within 60 days after publication of this report.

SAO Recommendation 1-C (6): The ETF should send a list of commercialization award applicants' officers and investors to the ETF Trustees.

The OOG agrees with this recommendation. The COD and TETF division will be responsible for implementing this recommendation, and will do so within 60 days after publication of this report.

SAO Recommendation 1-C (7): The ETF should announce all ETF grants and awards in a timely manner.

The OOG agrees with this recommendation, but would note that the events that concern the SAO have involved announcements made *after*, not *before*, execution of the contract. This often occurs because the TETF and the companies agree to delay the announcement until plans for a public event have been made, or for other reasons that increase the company's competitive advantage. The OOG believes that the "timeliness" of the announcement must take these objectives into account. The SAO report contends that TETF should announce awards when it executes a contract with the awardee "because the conflict of interest policy allows RCIC and TLSCIC board members to invest in or receive compensation from ETF recipients on the 90th day after the awards have been publicly announced." But the delay of the announcement only serves to extend (not shorten) this period, and thus only increases the protection that this aspect of the conflict policy provides.

Chapter 2: "The ETF Should Improve Its Review of ETF Recipients, RCICs, and the Texas Life Science Center to Ensure That They Comply with Requirements and Spend Funds Appropriately."

The OOG agrees that the TETF program will benefit from increased review and monitoring to ensure the recipients' and the RCICs' compliance with program requirements.

However, because the SAO's report focuses exclusively on the TETF's review of annual and interim reports, it incorrectly implies that these are the only ways in which the TETF monitors fund recipients. In fact, the TETF continuously monitors recipients through ongoing telephone calls, email communications, and in-person conversations. In addition, the RCICs are in regular contact with recipients, and report their findings to the TETF staff. Moreover, the TETF requests and receives additional reports, such as a survey that 118 (99%) of commercialization award recipients responded to in 2010.

Nevertheless, the OOG agrees that there is room for improvement in these areas, and has continually been engaged in efforts to implement those improvements. To continue strengthening the compliance review process, the OOG proactively conducted an internal review to assess the compliance needs of TETF program. As a result of this review, the OOG confirmed that the greatest challenges have resulted from the limited compliance resources dedicated to the TETF program, in light of the additional demands on those resources. For example, the SAO's report notes that, as of March 2011, TETF had not yet reviewed most of the 2010 compliance reports. But the report fails to acknowledge that, since December 2010, the TETF has been dedicating an inordinate amount of its time responding to the SAO's audit inquiries.

Having identified these issues through its own internal review, the OOG has recently created a Compliance and Oversight Division ("COD"), which will substantially improve the

compliance process within the TETF and other OOG granting divisions, by combining and leveraging existing resources within the OOG. This new COD employs professional auditors and contract compliance staff who individually and collectively have extensive monitoring and auditing experiences. The OOG has allocated additional resources to the review of compliance reports, and will soon be implementing new and additional procedures to improve this process.

Based on these comments and considerations, the OOG responds to the SAO Chapter 2 recommendations as follows:

SAO Recommendation 2 (1): The ETF should ensure that recipients submit all required reports in a timely manner.

The OOG agrees with this recommendation. The COD will be responsible for implementing processes to track and follow up with recipients to ensure that they submit all required reports in a timely manner, and are doing so as of the publication of this report.

SAO Recommendation 2 (2): The ETF should review recipients' reports in a timely manner.

The OOG agrees with this recommendation. The COD will be responsible for implementing processes to ensure that recipients' reports are reviewed in a timely manner, and is doing so as of the publication of this report.

SAO Recommendation 2 (3): The ETF should track when recipients' reports are due and received so that it can promptly follow up on reports not submitted and review in a timely manner the reports that are submitted.

The OOG agrees with this recommendation and, in fact, already tracks when recipients' reports are due and received. The COD is in the process of implementing a new database that will enhance the tracking and the generation of reminder notices that will be sent to recipients 60 and 30 calendar days before the due date of the compliance verification report, along with a notice that will be sent when the report is not received by close of business of the due date. The COD is responsible for implementing these processes and will complete implementation within 30 days after publication of this report. The TETF and General Counsel divisions will assist with follow up as necessary.

SAO Recommendation 2 (4): The ETF should evaluate the resources it needs to review recipients' reports.

The OOG agrees with this recommendation and has already conducted such an evaluation, which resulted in part in the creation of the new COD.

SAO Recommendation 2 (5): The ETF should conduct on-site visits at recipients.

The OOG agrees with this recommendation and, in fact, already conducts on-site recipient visits. In addition, the OOG contractually requires RCICs to visit each recipient at least annually and report back to the OOG. The TETF and General Counsel divisions will be responsible for continuing this practice, and the COD will also begin selecting recipients for onsite visits using a risk-based approach.

SAO Recommendation 2 (6): The ETF should include in recipients' contracts a standard format for reports that recipients must submit. At a minimum, the contracts should specify the detailed supporting documentation that recipients must submit to (1) demonstrate that they achieved required milestones, (2) report their financial status, and (3) support their expenditure of state funds.

The OOG agrees in part with this recommendation. Several RCICs have issued guidelines and recommended formats for such reporting. But because recipients are in highly diverse industries, requiring a completely standardized format for all reporting requirements would undermine the need to evaluate the types of information that may be specific and unique to each recipient. The OOG does agree that template reports should address the minimum three items listed, and the TETF division will be responsible for ensuring that such templates are made available within 60 days after publication of this report.

SAO Recommendation 2 (7): The ETF should retain the documentation it uses to verify recipients' achievement of milestones before making second disbursements of funds to recipients.

The OOG agrees with this recommendation, but it already retains such documents. The SAO has noted that, despite this requirement, it could not locate a few documents in older files. The COD will be responsible for ensuring that such documents are retained in accordance with the applicable document retention schedules, beginning upon publication of this report.

SAO Recommendation 2 (8): The ETF should ensure that RCICs and the Texas Life Science Center submit reports required by their contracts in a timely manner.

The OOG agrees with this recommendation. The COD will be responsible for implementing processes to track and follow up with RCICs to ensure that they submit all required reports in a timely manner, and are doing so as of the publication of this report.

SAO Recommendation 2 (9): The ETF should review in a timely manner the reports that the RCICs and the Texas Life Science Center submit.

The OOG agrees with this recommendation. The COD will be responsible for implementing processes to ensure that recipients' reports are reviewed in a timely manner, and are doing so as of the publication of this report.

Chapter 3: "The Office of the Governor Should Ensure That it Correctly Accounts for and Reports Financial Information Related to the ETF."

The OOG disagrees with most of the conclusions, implications, and recommendations in Chapter 3 of the SAO's report.

The SAO is correct that the OOG's annual *report to the Legislature* did not include "the value of ETF investments," but did report "that it had awarded \$170,047,349 in commercialization awards." This report completely complied with the Legislature's instructions in section 490.005 of the Texas Government Code, which requires that the report include "the total number and amount of awards made" and "the number and amount of awards made under Subchapters D, E, and F." The OOG report provided this information, as required by the Legislature. The statute also requires that the report include "a brief description of the equity position that the ... state ... may take in companies receiving awards and the names of the companies in which the state has taken an equity position," and the OOG report included that information. The statute also requires that the report include "the aggregate total of private sector investment," and the OOG report included these amounts. The statute does not, however, require that the report include the "value" of the state's investments in the TETF award recipients.

The SAO's conclusions regarding the OOG's *annual financial reports* are even more misleading. In its "Overall Conclusion" on the first page (page i) of its report, the SAO asserts that the OOG "does not report the value of the State's investments through the ETF on its financial statements." Yet in the body of its report (pages iii and 25), the SAO acknowledges that the OOG did report the value of its investment in one company. It then erroneously suggests that the OOG reported the value of this investment because it was the only one "from which the ETF has profited." In fact, as the SAO later acknowledges, the OOG reported the value only of that one investment because it was the only investment in a *publicly-traded* company, and thus the only investment that had a reasonably determinable value. Although the OOG reported the *amount* of each investment in a *privately-held* company on the TETF web site and in the annual report to the Legislature, it did not report a *value* of those investments in its annual financial report because the value of those investments is not reasonably determinable. As the SAO report acknowledges, of the 10 other states with "similar" programs that the SAO reviewed, only three of them even attempt to determine the value of their privately-held investments. The OOG carefully considered its options, but concluded that estimating a value that, in actuality, is not reasonably determinable would be more misleading than reporting only the amount of the actual investment.

The OOG follows an account reconciliation process, and in doing so discovered that \$6 million had not been encumbered in the fourth quarter of fiscal year 2010. Upon discovering this, the OOG encumbered this amount in the next reporting period for the first quarter of fiscal year 2011. The OOG agrees that, due to this one omission, the TETF encumbrances in the fiscal year 2010 annual financial report were understated by \$6 million (7%).

The OOG does not agree, however, that it “does not consistently encumber funds.” Under Section 490.101 of the Texas Government Code, the Governor, with the express written approval of the Lieutenant Governor and the Speaker of the House of Representatives, may award TETF funds. These TETF Trustees confirm their agreement and approval of an award by executing a letter and delivering it to the TETF division. Although section 490.101 requires that the Governor enter into a written contract with the recipient “before making an award,” it is the Trustees’ letter, and not the written contract, that legally authorizes the obligation of the state’s funds. The Comptroller’s Accounting Policy Statement 018 (APS 018), to which the SAO report refers, defines an “outstanding encumbrance” as “a contract, agreement, *or other action* that *legally obligates* state funds” (emphases added). After careful consideration, the OOG has concluded that, in full compliance with APS 018, the appropriate practice is to encumber the funds at the time of the TETF Trustees’ letter, which is the “other legal action” that authorizes the obligation, even though it is subject to and later memorialized through a written contract.

The OOG does not agree that “one contract was encumbered 2.5 years before the contract was signed.” The award to which this statement apparently refers was encumbered in May 2010, upon receipt of the Trustees’ letter, but was entered with an incorrect appropriation year of 2008. The OOG discovered this error during its routine reconciliation of May 2010, and corrected it in June 2010 to reflect the correct appropriation year.

Based on these comments and considerations, the OOG responds to the SAO Chapter 3 recommendations as follows:

SAO Recommendation 3 (1): The OOG should determine the appropriate value calculation methodology for the investments held by the ETF and report those investments correctly on its reports to the Legislature and on its annual financial reports.

The OOG disagrees with this recommendation based on its conclusion that the value of the state’s investments in the privately-held recipients is not realistically determinable, and thus reporting an estimated value would be misleading. However, the OOG agrees to confer with the SAO and the Office of the Comptroller to further explore this issue. The OOG’s Financial Services division will be responsible for doing this, and will begin the process within 30 days after publication of this report.

SAO Recommendation 3 (2): The OOG should record encumbrances in a consistent manner in its internal accounting system by following the Office of the Comptroller of Public Accounts' APS 018 and accounting standards.

The OOG agrees with this recommendation but believes that it already records encumbrances as required by APS 018. The OOG does not agree that APS 018 requires that the OOG encumber the funds only when a contract is signed, because the Trustees' letter constitutes an "other legal action," which occurs before the contract is signed and authorizes the legal obligation.

SAO Recommendation 3 (3): The OOG should comply with statutory and General Appropriations Act requirements to transfer ETF appropriations into a dedicated account.

The OOG agrees with this recommendation. The Financial Services division has been and remains responsible for ensuring the OOG's compliance with the legal requirements to transfer appropriations into a dedicated account, and it will continue to do so.

Chapter 4: "The ETF Should Improve Its Administration of Contracts with RCICs, the TLSCIC, and ETF Recipients."

The OOG agrees that, generally speaking, it appears beneficial to have consistency among the RCIC contracts, both as between the different RCICs and from year to year. But speaking specifically, it is neither practical nor advisable to do so. Because each RCIC is a separate independent entity that services a unique geographical area, it is often necessary to include terms in one contract that would not be necessary or advisable in another. Moreover, as the TETF program matures, the OOG continually evaluates the contracts and revises them when necessary to provide greater clarity or assurance.

The OOG must take a similarly-flexible approach when dealing with an entity's non-compliance with a contractual term. The purpose of the TETF is "to develop and diversify the economy of this state by: (1) expediting innovation and commercialization of research; (2) attracting, creating, or expanding private sector entities that will promote a substantial increase in high-quality jobs; and (3) increasing higher education applied technology research capabilities." TEX. GOVT. CODE § 490.002. It is not the purpose of the fund to avoid making disbursements whenever possible, or to force the entities to fail by terminating a contract any time the entity comes up short. The state is an investor in these entities. It is therefore in the state's best interest to help the recipients succeed, not to cause them to fail. The OOG has declared companies to be in default, and has refused to provide subsequent disbursements, when it had become apparent that the company could (or would) not comply with its obligations or was unlikely to succeed. But when agreeing to extend a contractual deadline has appeared to be in the best interest of the state, the OOG has appropriately chosen to do so.

The OOG does not agree with the SAO's conclusion that the practice of signing contracts after their stated effective date constitutes a "weakness." The parties to a contract may agree to make it effective on any particular date, which may be at any time prior to or after the date on which they sign the written document that memorializes their agreement. The parole evidence rule requires that certain contracts must be in writing and signed by the parties, but does not require that the signatures occur on or before the effective date. A contract may provide that it is effective, for example, on a specific date, or on the date last signed by the parties. If the contract specifies an effective date and is signed by the parties on a different date, the specified effective date will be the effective date.² In light of the numerous approvals that are required before the state can execute a contract, and in light of the benefits of having them become effective on a particular date, it is sometimes the better practice to agree to an effective date that pre-dates the date of execution. But before signing the contracts, the OOG reviews them to ensure that the parties can comply and have complied since the stated effective date, and that the requirements are thus in effect throughout the entire timeframe of the contract.

Based on these comments and considerations, the OOG responds to the SAO Chapter 4 recommendations as follows:

SAO Recommendation 4 (1): The ETF should obtain signatures on its contracts with RCICs and Texas Life Science in a timely manner.

The OOG agrees with this recommendation. The General Counsel division will be responsible for implementing it as of the publication of this report.

SAO Recommendation 4 (2): The ETF should pay RCICs and the Texas Life Science Center only for expenditures they incur during the contract period.

The OOG agrees in part with this recommendation. The TETF does not pay RCICs for expenditures, but instead contractually authorizes RCICs to use TETF funds only for certain described purposes. As a general rule, we agree that those purposes should relate to activities during the contract period, but we do not agree that there should never be exceptions to this general rule. The General Counsel and COD divisions will be responsible for implementing this recommendation following the publication of this report.

² See, e.g., *Langhoff Properties v. BP Productions NA*, 519 F.3d 256, 261 (5th Cir. 2008) ("All know that it is the specified effective date that controls, not the date that the document happens to be signed."); *Willson v. Superior Oil*, 274 S.W.2d 947, 951 (Tex. Civ. App. – Texarkana 1955, writ ref'd n.r.e.) ("We think it is clear that the parties intended the effective date . . . to be the date that it bore on its face, to wit, February 2, 1953, and we attach no significance to the fact that the instrument was not signed by [a party] until March 30, 1953 . . .").

SAO Recommendation 4 (3): The ETF should re-evaluate the responsibilities specified in its contracts with RCICs and the Texas Life Science Center.

The OOG agrees with this recommendation. The TETF and General Counsel divisions have been and will remain responsible for conducting these re-evaluations on an ongoing basis.

SAO Recommendation 4 (4): The ETF should clarify and enforce the record retention requirements in its contracts with RCICs and the Texas Life Science Center.

The OOG agrees with this recommendation. The COD and General Counsel divisions will be responsible for implementing it upon publication of this report.

SAO Recommendation 4 (5): The ETF should clearly define allowable expenditures in its contracts with RCICs and the Texas Life Science Center.

The OOG agrees with this recommendation. The TETF and General Counsel divisions have been and will remain responsible for conducting these re-evaluations on an ongoing basis.

SAO Recommendation 4 (6): The ETF should require RCICs and the Texas Life Science Center to have separate accounts for expenditures related to the ETF.

The OOG agrees with this recommendation. The General Counsel division will be responsible for implementing it in future contracts following publication of this report.

SAO Recommendation 4 (7): The ETF should sign contracts with ETF recipients on or before the contract effective date.

The OOG agrees that signing the contracts on or before the effective date is often the preferred practice. It does not agree that it should be a requirement, or that there should never be exceptions to this practice.